(21)

Nos. 161 and 162

In the Supreme Court of the United States

OCTOBER TERM, 1942

ESTATE OF CARL LEVIS, DECEASED, HENRY BLUMENTHAL AND MANFRED W. EHRICH, EXECUTORS, PETITIONERS

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 102–104) is not officially reported. The opinion of the United States Circuit Court of Appeals for the Second Circuit (R. 126–129) is not yet reported.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on May 21, 1942. (R. 129–130.) The petition for a writ of certiorari was filed on

June 19, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer bought and sold securities for his own account and also made a number of short sales. In connection with the short sales he paid various amounts to the lenders of the stock as premiums for the loans and to compensate for interim dividends on the borrowed stock. Are those amounts deductible as business expenses under Section 23 (a) of the Revenue Acts of 1934 and 1936?

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:
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> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.
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> * * * * *
>
> (j) *Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117 (d).
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> * * * * *
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> SEC. 117. CAPITAL GAINS AND LOSSES.
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> * * * * *
>
> (d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital

assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * *

(e) *Gains and Losses from Short Sales, etc.*—For the purpose of this title—

(1) gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets; * * *.

(The corresponding sections of the Revenue Act of 1936, c. 690, 49 Stat. 1648, are the same.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934.

> ART. 23 (a)–1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 23 (b)–1 to 23 (q)–1. Double deductions are not permitted. Amounts deducted under one provision of the Act can not again be deducted under any other provision of the Act. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See article 22 (a)–5.) Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from

home solely in the pursuit of a trade or business (see article 23 (a)–2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

ART. 24–2. *Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23 (1).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid

in selling securities, when such commissions are not an ordinary and necessary business expense, are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attorneys' fees, and executors' commissions, are chargeable against the corpus of the estate and are not allowable deductions. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See article 22 (a)-17). An assessment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the Act, may in certain cases represent a loss. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.

(The corresponding articles of Treasury Regulations 94, promulgated under the Revenue Act of 1936, are to the same effect.)

STATEMENT

This case involves the income tax liability of Carl Levis, now deceased, for the years 1934–1936, inclusive. The facts were stipulated (R. 34–36), and were restated by the Board of Tax Appeals substantially as follows:

Carl Levis was a member of the New York Stock Exchange during the three taxable years. He was actively engaged during those years in the business of buying and selling securities for his own account. He made a number of short sales during those years in connection with which he borrowed shares for delivery. He agreed with the lender that he would pay to the lender the amount of all dividends which should be paid on such shares until the borrowed shares were returned. He also paid, in some cases, a premium to the lender as a consideration for the borrowed shares. Levis paid commissions to other brokers in 1936 in connection with purchases and sales of stock. The Commissioner, in determining the deficiencies, disallowed deductions for dividends on borrowed shares, premiums for the use of borrowed shares and, for 1936, the commissions paid on purchases and sales.[1] (R. 103.)

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[1] The taxpayer accepts the adverse ruling with respect to commissions paid on sales. (Pet. 6.)

The Board decided in favor of the taxpayer on all issues except the purchase commissions (R. 104), but the court below reversed (R. 129), holding that none of the items in controversy was deductible.

ARGUMENT

The court below correctly ruled that the amounts paid by the taxpayer to the lender, whether as interim dividends or as premiums, were items of a capital nature. Such items may be reflected in computing gain or loss on the short sale, but they may not be deducted as "expenses" from ordinary income. The result reached below is in accord with *Helvering* v. *Winmill,* 305 U. S. 79, holding that purchase commissions are not deductible as expenses, and *Spreckels* v. *Helvering,* Nos. 581–582, 1941 Term, holding that sales commissions are similarly not deductible. In both the *Winmill* and the *Spreckels* cases, as in the instant case, the taxpayer was an active trader in securities, but the Court held that the amounts in question were of a capital nature and could be reflected as such in the computation of gain or loss upon the particular securities, but could not be deducted generally as "expenses."

The petitioners rely primarily upon *Dart* v. *Commissioner,* 74 F. (2d) 845 (C. C. A. 4th), in which the result was substantially contrary to the decision herein. But the *Dart* case was decided prior to both the *Winmill* and *Spreckels* decisions,

and there is no reason to believe that the Fourth Circuit today would refuse to apply the principles laid down in those cases to the situation here presented.[2] In the circumstances it cannot be said that there is a present conflict between the Second and the Fourth Circuits on this question.

Moreover, it is significant that in granting certiorari in *Wilmington Trust Co.* v. *Helvering,* No. 775, 1941 Term, this Court limited the writ to the narrow issue whether the Circuit Court of Appeals erred in reversing the determination of the Board of Tax Appeals that certain sales made by the taxpayer were not in fact short sales. The court had held (*Helvering* v. *Wilmington Trust Co.,* 124 F. (2d) 156 (C. C. A. 3d)), that they were short sales and that the dividend charges were in the nature of capital expenditures which could not be offset against dividends credited to the taxpayer's long account on the theory that they were business expenses. There, as here, the taxpayer was an active trader, and the Court pro-

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[2] It seems clear that the interim dividends and premiums paid to the lender of stock to carry the short account were just as much a part of the basic capital transaction as the brokerage commissions. As pointed out by the court below (R. 128), no gain or loss is realized upon a short sale until the transaction is closed by a covering purchase and a settlement with the lender of the borrowed stock. What is paid to the lender for use of the borrowed stock, being a necessary prerequisite to the completion of the capital transaction, should be regarded as a selling charge and an offset against the price received, as truly as is a selling commission paid to the broker.

ceeded upon the implicit assumption that the amounts in question would not have been deductible if the sales were in fact short sales.

In the light of the opinions in the *Winmill* and *Spreckels* cases and the treatment of this question in the *Wilmington Trust* case, there would not seem to be any occasion for review of the issue here.

If the Court should nevertheless grant the petition, we wish to reserve the right to make the further contention that the amounts in question are in any event not deductible, since petitioner's private trading account cannot constitute a "trade or business" within the meaning of Section 23 (a). Cf. *United States* v. *Pyne,* 313 U. S. 127; *City Bank Co.* v. *Helvering,* 313 U. S. 121; *Higgins* v. *Commissioner,* 312 U. S. 212.

CONCLUSION

The decision is in accord with recent decisions of this Court. The petition for writ of certiorari should be denied.

Respectfully submitted,

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JULY 1942.

U. S. GOVERNMENT PRINTING OFFICE: 1942